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Supreme Court, U.S.
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No. 07-

IN THE

Supreme Court of the United States

BILLY D. DOBBS JR.,

Petitioner,

v.

RICHARD MEHRLICH,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

The Bankruptcy Court granted the Respondent's motion for summary judgment in the bankruptcy proceeding and declared the Respondent's debt against the Petitioner non-dischargeable based on the finding of fraud in a prior arbitration proceeding. The Bankruptcy Court's decision was affirmed by the District Court and the Court of Appeals for the Second Circuit. The question presented is:

Whether the Second Circuit erred by holding, in conflict with the Court's and the Eighth and Fifth Circuit's prior decisions, as well as the Second Circuit's own precedent, that an arbitrator's finding of fraud based on a standard different than the standard for fraud under Section 523(a)(2)(A) of the Bankruptcy Code can be given collateral estoppel effect to deem a debt non-dischargeable under Section 523(a)(2)(A).

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OPINIONS BELOW

The order of the court of appeals denying the petition for rehearing en-banc (App., *infra*, 15a-16a) is not reported. The summary order of the court of appeals (App., *infra*, 1a-3a) is not reported. The district court opinion (App., *infra*, 4a-9a) is not reported. The bankruptcy court decision (App., *infra*, 10a-14a) is not reported. The arbitrator's decision (App., *infra*, 17a-43a) is not reported.

JURISDICTION

The summary order of the court of appeals was entered on June 29, 2007. By order entered on September 11, 2007, the court of appeals denied the Petitioner's timely petition for rehearing en banc (App., *infra*, 15a-16a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

Title 11 United States Code, Section 523(a)(2)(A)

Exceptions to Discharge

> (a) a discharge under section 727, 1141, 1228(a), 1228(b) or 1328(b) of this title does not discharge an individual debtor from any debt –
>
> . . .

> (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by –
>
> > (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition.

STATEMENT OF THE CASE

This case involves one of the most oft-litigated Bankruptcy non-dischargeability issues. Namely, whether, and under what specific circumstances may a Bankruptcy Court grant summary judgment deeming a debt non-dischargeable based solely on a determination of fraud reached in a prior arbitration proceeding.

In this case, the Second Circuit affirmed the District Court's decision that the Bankruptcy Court did not err in granting summary judgment in favor of Respondent deeming the debt the Petitioner owed to Respondent non-dischargeable based on the decision of fraud reached by an arbitrator. However, the Second Circuit's holding runs afoul of the Court's decision in *Brown v. Felsen*, 442 U.S. 127 (1979) since, according to *Brown*, the only way that the arbitrator's decision could have been given collateral estoppel effect is if the arbitrator's finding of fraud, and the facts related thereto, was based on a standard identical to the standard needed for a finding of fraud under 11 U.S.C. § 523(a)(2)(A) ("Section 523(a)(2)(A)"). However, while the arbitrator did make a finding of fraud, he did so using a different formula, and not the standard used to find fraud under Section 523(a)(2)(A).

Background

The Petitioner was an investment fund manager. In or about 1997, the Respondent invested $2 million in Formula Fund L.L.C. ("Formula Fund"), a hedge fund managed by the Petitioner. In 1998, the Petitioner invested a portion of Formula Fund's assets in an entity known as Amercon International Incorporated ("Amercon"), a company that manufactured aircraft parts. The Petitioner served as the chairman of Amercon's board of directors. In late 1998, shares of Amercon, which were valued at $450 per share, represented 18% of Formula Fund's total portfolio. At the end of 1998 or early in 1999, the Petitioner decided to revalue the Amercon shares to $2,950 per share. This was done during the height of the internet stock boom when many companies who had no revenues and no income were being valued at extraordinary numbers based on their potential. The Petitioner believed that Americon had similar potential upside. After the revaluation, Amercon shares represented more than 50% of the fund's assets.

After having a series of communications with the Respondent with respect to his investment in the fund, in early February, 1999, the Petitioner met with the Respondent in an informal setting and made his case for the Respondent to maintain his investment in the fund. The Respondent, who was a seasoned and savvy investor and was well aware of the risks and rewards associated with these types of funds, decided to keep his money in the fund in the hope of benefitting from the growth potential. When the Respondent ultimately redeemed his investment, he received only $260,631.

As often happens in these situations, as soon as the Respondent sustained losses he immediately turned around to sue the Petitioner. While the Petitioner's management of the fund and assessment of the valuation of the stocks therein may not have been perfect they were certainly not malevolent. Indeed, what happened to the Respondent was going on all over where many sophisticated investors watched their holdings in internet companies and the like turn to dust overnight.

On February 8, 2002, the Respondent commenced arbitration against the Petitioner. On December 1, 2003, before the arbitration hearing took place, the Petitioner filed a petition pursuant to Chapter 7 of the United States Bankruptcy Code. After obtaining relief from the automatic stay, on November 17, 2004, the arbitrator issued an opinion concluding that the Petitioner had committed fraud against the Respondent. *See* App., *infra*, 38a-41a. The Respondent then moved Judge Drain to have his debt excepted from the Petitioner's bankruptcy discharge under Section 523(a)(2). In granting the Respondent's motion, the Bankruptcy Court gave collateral estoppel effect to the arbitrator's fact-finding, and concluded that the Petitioner's actions constituted fraud under New York law. *Id.*, 10a-14a.

While a finding of the elements of common law fraud may typically be given collateral estoppel effect under Section 523(a)(2)(A), the Arbitrator's Decision, by its own analysis, was not based on all the elements of common law fraud.

The Arbitrator's Decision correctly set forth the elements for a common law finding of fraud, as follows:

> "The elements constituting a cause of action for fraud are representation of a material existing fact, falsity, scienter, deception and injury," *New York Univ. v. Continental Ins.* Co., 87 N.Y.2d 308, 318, 639 N.Y.S.2d 283, 662 N.E.2d 763) *citing*; *Channel Master Corp. v. Aluminium Ltd. Sales*, 4 N.Y.2d 403, 176 N.Y.S.2d 259, 151 N.E.2d 833. When the cause of action is based on a material omission, the plaintiff must prove "a material omission of fact which was false and known to be false by defendant, made for the purpose of inducing the other party to rely upon it, justifiable reliance of the other party on the misrepresentation or material omission, and injury. Lama Holding Co. v. Smith Barney Inc. et al., 646 N.Y.S.2d 76, 88 N.Y.2d 413, 668 N.E.2d 1370, (Ct. App. 1996). In New York, a civil fraud must be proven by clear and convincing evidence.

App., *infra*, 38a.

Thus, when a state court makes such factual findings, and indeed if the Arbitrator had made factual findings consistent with those elements of common law fraud, they may be given collateral estoppel effect. However, the Arbitrator did not base his decision on the standards which he himself enumerated. In order to comport with the aforementioned fraud standard, the Decision should have articulated by clear and convincing evidence the elements of a common law fraud, with all of its factual

predicates. Instead, the Arbitrator sets forth an entirely new legal standard not based on the elements of common law fraud.

In that regard, the Decision states:

> However, at the meeting in early February 1999, Dobbs had a duty to disclose truthfully . . . Dobbs not only had a fiduciary duty to disclose by reason of his status as the person who controlled the Fund' Manager, but once he voluntarily undertook to explain the 1998 year-end results to Mehrlich, he assumed a duty to speak truthfully and completely.

Id., 39a-40a. Thus, the Arbitrator based his finding of fraud, not on the elements of common law fraud, but on an entirely new "duty" to disclose. This duty is not part of the standard for a finding of common law fraud and is therefore not a valid basis for a finding of nondischargeability pursuant to Section 523(a)(2)(A). Apparently, the only way the Arbitrator was able to reach his decision was by combining a breach of fiduciary duty standard with some elements of fraud. This, however, does not create the identity of standards required under the Court's decision in *Brown v. Felsen, supra*, in order to create collateral estoppel pursuant to Section 523(a)(2)(A).

The Petitioner argued before the Bankruptcy Court, as well as the District Court and Second Circuit, that the legal standard utilized by the Arbitrator was a convoluted mixture of a breach of fiduciary duty combined with fraud, which, as a matter of law, could not give rise to collateral estoppel.

The Bankruptcy Court as well as the District Court did not fundamentally disagree with the Petitioner's aforementioned argument. Rather, they circumvented the argument by asserting a new legal thesis of "factual" collateral estoppel. The Second Circuit echoed the decisions of the lower courts, and referred to the Court's clear mandate in *Brown v. Felsen, supra,* that collateral estoppel can only be applied in this situation if the factual determinations were reached using standards identical to those needed for a finding of fraud under the Bankruptcy Code, as "dicta". *App., infra,* 2a-3a. In other words, the Second Circuit held, contrary to *Brown,* that even though the legal standards were not identical the factual findings of the arbitrator were sufficient to give rise to collateral estoppel.

REASONS FOR GRANTING THE PETITION

I. The Second Circuit's Decision Conflicts With The Court's Decision In *Brown* Which Established That, Contrary To The Second Circuit's Notion, A Bankruptcy Court Cannot Utilize "Factual" Collateral Estoppel When The Underlying Finding Of Fraud Was Based On A Legal Standard Different Than That Needed For Fraud Under Section 523(a)(2)(A).

Appellant's argument to the lower courts was that, pursuant to *Brown,* the Arbitrator's finding of fraud cannot be given collateral estoppel effect in the bankruptcy court since it was based on a legal standard different than that needed for a finding of fraud under Section 523(a)(2)(A).

The standard for a finding of fraud under Section 523(a)(2)(A) is set forth in *Fellows, Read & Associates, Inc. v. Rieder*, 194 B.R. 734 (1996), aff'd 1997 U.S. App. Lexis 13818, as follows:

> To bar discharge from a debt under Section 523(a)(2)(A), a creditor must prove ... the following factors: (1) the debtor made a representation; (2) he knew the representation was false; (3) he intended to deceive the creditor; (4) the creditor relied on the representation; and (5) his reliance was the proximate cause of his damage.

Id. at 737. *see also Boyuka v. White*, 128 Fed. Appx. 994, 998 (4th Cir. 2005); *Carrol v. Quinlivan*, 434 F.3d 314, 317 (5th Cir. 2005); *Peoples State Bank v. Crim*, 149 Fed. Appx. 427, 430 (6th Cir. 2005); *Heptacor Inc. v. Luster*, 50 Fed. Appx. 781, 784 (7th Cir. 2002); *Diamond v. Kolcum*, 285 F.3d 822, 827 (9th Cir. 2002).

The Arbitrator did not utilize the above standard, but, instead, employed a standard consisting not only of common law fraud, but also breach of fiduciary duty.

In that regard, the Arbitrator stated that it was the Petitioner's failure to discharge his duty to disclose and speak truthfully which led to his finding of fraud. *See, App., infra*, 39a-40a. Apparently, the only way the Arbitrator was able to reach his decision was by combining the legal standards under breach of fiduciary duty with some elements of fraud. This, however, does not create the identity of standards required under *Brown* in order to create collateral estoppel pursuant to Section 523(a)(2)(A).

In point of fact, the Court, in *Brown*, clearly provided that the standard used to find fraud in a proceeding must have been the identical standard used to find fraud for non-dischargeability under the Bankruptcy Code, as follows:

> If, in the course of adjudicating a state-law question, a state court should determine *factual issues using standards identical to those of § 17*[1], then collateral estoppel, in the absence of countervailing statutory policy, would bar relitigation of those issues in the bankruptcy court. (emphasis added).

Id., at 139, note. 10. *See, App., infra*, 2a-3a.

In denying the Appeal, the Second Circuit stated the following regarding the above: "This dicta is merely a general statement that the ordinary prerequisites for application of collateral estoppel apply . . ." *Id.*, 3a.

However, the Second Circuit erred in treating the quoted language as merely a general statement that the "ordinary" prerequisites to collateral estoppel would apply when seeking to utilize collateral estoppel in connection with Section 523(a)(2)(A). In point of fact, *Brown* is precedent that "factual" collateral estoppel may only be utilized by the bankruptcy court in connection with Section 523(a)(2)(A) when there is an identity of standards.

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1. § 17 being the statutory predecessor, under the Bankruptcy Act to § 523 of the Bankruptcy Code.

It is evident that the Second Circuit rejected *Brown*'s more exacting standard for "factual" collateral estoppel in connection with Section 523(a)(2)(A) by their citing to *Evergreens v. Nunan*, 141 F.2d 927 (2d Cir. 1944), a Second Circuit tax case. *App., infra*, 2a. Contrary to the Second Circuit's assertion, it is *Brown* which, subsequently to *Evergreens*, carved out the precedent for "factual" collateral estoppel in connection with Section 523(a)(2)(A).

Thus, *Brown* vitiated any precedential value *Evergreens* may have had at one time in connection with "factual" collateral estoppel and Section 523(a)(2)(A).

Inasmuch as the Second Circuit, tacitly, asserted that the Court in *Brown* did not impose a more exacting standard when invoking collateral estoppel under Section 523(a)(2)(A), the Court should grant certiorari to decide whether the Second Circuit erred, since, on its face, the plain language of the Court in *Brown* does impose the narrower standard, and the Second Circuit's decision and the Court's are in conflict.

II. There Is A Square And Explicit Circuit Conflict On The Important Issue Of When The Bankruptcy Court May Give Prior Determination Of Fraud Collateral Estoppel Effect In Relation To Section 523(a)(2)(A).

The Second Circuit's affirmance of the Bankruptcy Court's finding of fraud based on the Arbitration Award conflicts with the holdings of the Eighth and Fifth Circuits regarding this issue. While the Second Circuit gave the Arbitration Award collateral estoppel effect

even though the arbitrator's finding of fraud was based on a different legal standard mixing elements of fraud with that of breach of fiduciary duty, the Eighth and Fifth Circuits have held that collateral estoppel cannot be applied in this situation since there must be an exact identity of the legal standard for fraud under Section 523(a)(2)(A). Thus, the Circuits are split regarding this issue, and the Court's intervention is needed to, once and for all, clearly define when a prior decision of fraud can be given collateral estoppel effect under Section 523(a)(2)(A) in a bankruptcy proceeding.

For example, in *Owens v. Miller*, 276 F.3d 424 (8th Cir. 2002), the Eighth Circuit held that a finding of fraud under § 20(a) of the Securities Exchange Act (§ 20(a)) can not be extended to Section 523(a)(2)(A). In that regard, the Eighth Circuit stated as follows:

> Section 523 of the Bankruptcy Code addresses actual, traditional fraud, and we are not persuaded that it should be read in such a way as to encompass the nontraditional liability imposed under § 20(a). Like the Eleventh Circuit, we believe that the extension of § 20(a) liability to § 523 of the Bankruptcy Code should come from Congress and not the Judiciary. See Hoffend, 261 F.3d at 1154.

Id. at 429.

Thus, the Eight Circuit's refusal to impute fraud under Section 523(a)(2)(A) by way of § 20(a) since § 20(a) encompasses a standard different from standard under Section 523(a)(2)(A), *i.e.*, common law fraud,

demonstrates a clear conflict with the Second Circuit's holding in this case where the Bankruptcy Court imputed fraud under Section 523(a)(2)(A) by way of the convoluted legal standard for fraud utilized in the Arbitration Award.

In short, the Eighth Circuit holds that only where standards exactly identical to Section 523(a)(2)(A) are used, can a finding of fraud be a basis for a finding of collateral estoppel. The rationale for this is set forth in *Owens*, "We are mindful of our duty to construe exceptions to discharge narrowly . . ." *Id.* In other words, *Owens* stands for the proposition that "fraud" as it is used in Section 523(a)(2)(A), has a specific meaning, and it is not for the courts to extend that meaning to include frauds as they are defined elsewhere, even by statute.

Thus, the Second Circuit's affirmance of a collateral estoppel under Section 523(a)(2)(A) when the finding of fraud was based on a convoluted standard different than fraud under Section 523(a)(2)(A) is a direct conflict with the Eighth Circuit's prior holding on this issue.

In addition, the Second Circuit's holding apparently conflicts with the Fifth Circuit's application of collateral estoppel to the issue of fraud and dischargeability in a bankruptcy proceeding as well. The Fifth Circuit's decision in *Miller v. J.D. Abrams, Inc., (Matter of Miller)*, 156 F.3d 598, 602 (5th Cir., 1998), *cert. denied*, 526 U.S. 1016, 119 S. Ct. 1249, 143 L. Ed. 2d 347 (1999) as interpreted by the bankruptcy court in *Federal Insurance Company v. Gilson*, 250 B.R. 226 (Bnkr. E.D. VA. 2000), provides for the necessity of identity of standards to apply collateral estoppel as follows:

> The Supreme Court pointed out that the elements of a state law fraud or other action may not be the same as the elements of nondischargeability. For example, under § 523(a)(4), fraud by a fiduciary is not dischargeable. But, the nature of a fiduciary under § 523(a)(4) may be different, and narrower, than under state law. Davis v Aetna Acceptance Co., 293 U.S. 328, 333, 55 S. Ct. 151, 153, 79 L. Ed. 393 (1934); Miller v. J.D. Abrams, Inc., (Matter of Miller), 156 F.3d 598, 602 (5th Cir., 1998), cert. denied, 526 U.S. 1016, 119 S. Ct. 1249, 143 L. Ed. 2d 347 (1999); 4 COLLIER ON BANKRUPTCY P 523.10[1][C], at 523-73 (15th ed. rev., 1998).
>
> For these reasons — the waste of resources by creditors, debtors and courts in forcing the litigation of all potential dischargeability issues in every pre-petition collection case for fear that the debtor might file bankruptcy in the indeterminate future; the expertise of the bankruptcy courts in resolving dischargeability issues; and curbing creditor abuse — the Supreme Court declined to give res judicata effect to state court judgments obtained prior to the filing of a petition in bankruptcy. n8

Id. at 238.

Thus, the case at bar, where the Second Circuit gave the Arbitrator's Decision preclusive effect even though the fraud standard used by the Arbitrator is not identical to the fraud needed for Section 523(a)(2)(A), conflicts with the Fifth Circuit.

III. The Second Circuit's Decision In *Ball v. A.O. Smith Corp.* Supports The Petitioner's Argument That An Identity Of Standards Is Required For "Factual" Collateral Estoppel Under Section 523 Of The Bankruptcy Code, And, Thus, The Decision In This Case Conflicts With The Second Circuit's Own Precedent.

Furthermore, the Second Circuit in *Ball*, apparently the very cornerstone of the Summary Order (*See App., infra*, 3a), explicitly expounds the notion that a prior finding can be given "factual" collateral estoppel in a bankruptcy proceeding only if the standard used in the prior proceeding was identical to the standard under the Bankruptcy Code.

In *Ball*, the Second Circuit held that the bankruptcy court properly used a judgment of sanctions in the form of defense costs against an attorney under 28 U.S.C. § 1927 and Rule 11 of the Federal Rules of Civil Procedure to deem the debt nondischargeable under Section 523(a)(6) of the Bankruptcy Code ("Section 523(a)(6)"). The Second Circuit did so despite the fact that the sanctions required a showing that the lawsuit instituted by Ball was "unreasonable and for an improper purpose" while nondischargeability under Section 523(a)(6) requires that the debt be from "willful or malicious injury."

In doing so, the Second Circuit noted that the Fifth Circuit (who imposed the sanction), when deciding whether to award sanctions under § 1927 "has adopted *standards* for such an award *requiring findings that are the equivalent* of malice." *Id.*, at 70. (emphasis added.)

Thus, the Second Circuit, in *Ball*, actually supports the Petitioner's position that, in order to invoke "factual" collateral estoppel, both proceedings must have identical standards.

It follows that the Second Circuit's holding in this case, that affirmed a finding of fraud for non-dischargeability even though the Arbitrator employed a convoluted standard completely different than that needed to establish fraud under Section 523(a)(2)(A), conflicts with its prior holding.

Indeed, *Ball* demonstrates that the Second Circuit has previously followed the precedent in *Brown*, showing that the panel's decision not only conflicts with Supreme Court precedent, but prior Second Circuit holdings as well.

Accordingly, the Court's intervention is necessary to resolve the conflict between the Second Circuit and Eighth and Fifth Circuits, and, indeed, to secure and maintain uniformity in the Second Circuit as well.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A — SUMMARY ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DATED JUNE 29, 2007

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

No. 06-3885-bk

In re: BILLY D. DOBBS Jr.,

Debtor.

BILLY D. DOBBS JR.,

Debtor-Appellant,

v.

RICHARD MEHRLICH,

Appellee.

June 29, 2007

SUMMARY ORDER

PRESENT: Hon. JOSÉ A. CABRANES, Hon. REENA RAGGI, Circuit Judges, Hon. EDWARD R. KORMAN, District Judge*.

Appeal from a judgment of the United States District Court for the Southern District of New York (Denise Cote, *Judge*).

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* The Honorable Edward R. Korman, of the United States District Court for the Eastern District of New York, sitting by designation.

Appendix A

UPON CONSIDERATION WHEREOF, IT IS HEREBY ORDERED, ADJUDGED, AND DECREED that the judgment of the District Court is **AFFIRMED.**

Debtor-appellant appeals from an August 15, 2006 judgment of the District Court affirming an August 4, 2005 order of the United States Bankruptcy Court for the Southern District of New York (Robert D. Drain, *Bankruptcy Judge*), which deemed debtor-appellant's debt of $751,462.50 plus interest to appellee non-dischargeable under 11 U.S.C. § 523(a)(2)(A). We assume the parties' familiarity with the facts and procedural history of the case.

We review *de novo* the District Court's application of the doctrine of collateral estoppel. *Chartier v. Marlin Mgmt., LLC*, 202 F.3d 89, 93 (2d Cir.2000). Debtor-appellant provides no support, and we have found none, for his argument that collateral estoppel does nothing more than permit "the utilization of the legal conclusion of one court with respect to a given set of facts, by another court." This Court has long recognized the preclusive effect of prior factual findings. *See, e.g., The Evergreens v. Nunan*, 141 F.2d 927, 928 (2d Cir.1944). Nor do we find persuasive debtor-appellant's assertion that dicta in *Brown v. Felsen*, 442 U.S. 127, 99 S.Ct. 2205, 60 L.Ed.2d 767 (1979), changed the fundamental rules of collateral estoppel with respect to § 523. *See id.* at 139 n. 10, 99 S.Ct. 2205 ("If, in the course of adjudicating a state-law question, a state court should determine factual issues using standards identical to those of [the precursor to § 523], then collateral estoppel, in the

absence of countervailing statutory policy, would bar relitigation of those issues in the bankruptcy court."). This dicta is merely a general statement that the ordinary prerequisites for application of collateral estoppel apply, and plaintiff has not explained how the allegedly incorrect analysis used by the arbitrator affected the parties' incentives to litigate the particular facts at issue or rendered those particular facts unnecessary to the arbitrator's decision. *See Ball v. A.O. Smith Corp.*, 451 F.3d 66, 69 (2d Cir.2006). Finally, we think that it was entirely proper for the District Court to decline to consider debtor-appellant's argument, raised for the first time in its reply brief, regarding proximate causation.

We have considered all of debtor-appellant's arguments and find them without merit. The District Court's judgment is **AFFIRMED.**

FOR THE COURT,
Catherine O'Hagan Wolfe, Clerk of Court

By _____
Oliva M. George, Deputy Clerk

APPENDIX B — MEMORANDUM OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK DATED AND FILED JULY 20, 2006

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

05 CIV. 9817 (DLC)

In re

BILLY D. DOBBS, JR.,

Debtor.

BILLY D. DOBBS, JR.

Appellant,

v.

RICHARD MEHRLICH,

Appellee.

July 20, 2006

MEMORANDUM OPINION & ORDER

DENISE COTE, District Judge:

Appellant Billy D. Dobbs, Jr. ("Dobbs") brings this action to reverse the August 4, 2005 order of Bankruptcy Judge Robert D. Drain (the "Bankruptcy Court Order") deeming Dobbs's debt of $751,462.50 plus interest to appellee Richard Mehrlich ("Mehrlich") non-

dischargeable under 11 U.S.C. § 523(a)(2). Section 523(a)(2) provides that a debtor may not escape liability for a debt obtained by "false pretenses, a false representation, or actual fraud." 11 U.S.C. § 523(a)(2)(A). Dobbs argues that in making his ruling, Judge Drain gave improper collateral estoppel effect to an arbitrator's determination that Dobbs had committed fraud. Mehrlich cross-moves for an affirmance of the Bankruptcy Order. For the reasons set forth below, the Bankruptcy Court Order is affirmed.

The following summary of relevant events is taken from Mehrlich's statement of facts, which Dobbs does not contest. In 1997, Mehrlich invested $2 million in Formula Fund L.L.C. ("Formula Fund"), a hedge fund managed by Dobbs. In 1998, Dobbs invested a portion of Formula Fund's assets in Amercon International Incorporated ("Amercon"), a company that manufactured aircraft parts. Dobbs served as the chairman of Amercon's board of directors. In late 1998, shares of Amercon, which were valued at $450 per share, represented 18% of Formula Fund's total portfolio. At the end of 1998 or early in 1999, Dobbs decided to revalue the Amercon shares to $2,950 per share. After the revaluation, which helped hide Formula Fund's other losses, Amercon shares represented more than 50% of the fund's assets.

Prior to the revaluation, Mehrlich had sent a withdrawal notice to Dobbs. Dobbs did not honor the request. In early 1999, Dobbs sent Mehrlich a quarterly report for Formula Fund, showing a loss of 0.96% for

1998, compared to a gain of 28.55% for the S & P 500 over the same period. On January 19, 1999, Dobbs telephoned Mehrlich and asked him not to withdraw his money from Formula Fund. In early February, Dobbs met with Mehrlich and made his case for Mehrlich to maintain his investment in the fund. He did not tell Mehrlich that Amercon stock represented more than half of Formula Fund's stated value; indeed, he did not mention Amercon at all. Mehrlich decided not to withdraw his capital at that time. When Mehrlich ultimately redeemed his investment, he received only $260,631.

On February 8, 2002, Mehrlich commenced arbitration against Dobbs. On December 1, 2003, before the proceedings had begun, Dobbs filed a petition pursuant to Chapter 7 of the United States Bankruptcy Code. On November 17, 2004, the arbitrator issued an opinion concluding that Dobbs had committed common law fraud against Mehrlich. Mehrlich then moved Judge Drain to have his debt excepted from Dobbs's bankruptcy discharge under Section 523(a)(2). In granting Mehrlich's motion, Judge Drain gave collateral estoppel effect to the arbitrator's fact-finding, and concluded that Dobbs's actions constituted fraud under New York law.

Discussion

A district court "may affirm, modify, or reverse a bankruptcy judge's judgment, order, or decree." Rule 8013, Fed. R. Bankr.P. The court must review the

Appendix B

Bankruptcy Court's findings of fact for clear error and its legal conclusions de novo. *In re Robert N. Kornfield*, 164 F.3d 778, 783 (2d Cir.1999). Here, Dobbs does not dispute any of Judge Drain's factual findings, nor does he contend that an arbitration decision cannot effect collateral estoppel.[1] In making this appeal, he argues simply that the arbitrator applied the wrong standard for fraud, and that Judge Drain erred in giving collateral estoppel effect to the arbitrator's flawed legal conclusion.[2]

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1. In any event, the Second Circuit has clearly held that an arbitration decision may be given collateral estoppel effect

> if the proponent can show with clarity and certainty that the same issues were resolved. Collateral estoppel is permissible as to a given issue if (1) the identical issue was raised in a previous proceeding; (2) the issue was actually litigated and decided in the previous proceeding; (3) the party had a full and fair opportunity to litigate the issue; and (4) the resolution of the issue was necessary to support a valid and final judgment on the merits.

Bear, Stearns & Co., Inc. v. 1109580 Ontario, Inc., 409 F.3d 87, 91 (2d Cir.2005) (citation omitted).

2. In his reply brief, Dobbs argues for the first time that the Bankruptcy Order should be reversed because Judge Drain did not make a finding that Mehrlich's reliance on Dobbs's purported fraud was the proximate cause of the losses. Arguments raised for the first time in a reply memorandum, however, will not be considered. *See Cioffi v. Averill Park Central School Dist. Board of Ed.*, 444 F.3d 158, 169 (2d Cir.2006); *In re WorldCom Sec. Litig.*, 352 F.Supp.2d 472, 494 n. 32 (S.D.N.Y. 2005).

Dobbs's argument is based on an obvious misreading of Judge Drain's opinion, which was delivered orally on July 7, 2005. Dobbs contends that Judge Drain adopted the reasoning of the arbitrator, who, in making his determination that fraud had been committed, referenced Dobbs's "fiduciary duty" to Mehrlich. Dobbs suggests that this reference amounted to the creation of "a new legal standard and obligation . . . out of whole cloth." Judge Drain, however, explicitly disavowed any reliance on the arbitrator's suggestion that Dobbs owed Mehrlich a fiduciary duty, calling the mention "superfluous." Instead, Judge Drain gave collateral estoppel effect only to the *facts* found by the arbitrator. After discussing certain of the arbitrator's factual holdings, he drew his own legal conclusions:

> I find that [the factual] findings by the arbitrator do serve as a basis for the collateral estoppel under Section 523(a)(2)(A). . . . Under New York law, actual fraud may be predicated not only upon an actual misrepresentation, but also a material omission. Such conduct may support a fraud cause of action if the omission was known to the defendant, made with the purpose of inducing the other party to rely on it, and the plaintiff has justifiably relied upon the omission and it has caused injury . . . [T]he arbitrator's reference to a fiduciary duty by Mr. Dobbs on page 20 as the arbitrator himself acknowledges is superfluous given the facts he outlines. *The real duty here* was Mr. Dobbs'[s] duty, having provided partial and

> incorrect information to give Mr. Mehrlich a full picture and not to omit material disclosure with regard to the funds[']investment in Americon and the valuation of Americon. . . .

(Emphasis supplied.)

Dobbs concedes that "a finding of the elements of common law fraud may typically be given collateral estoppel effect under § 523." Furthermore, he does not point to any errors in Judge Drain's legal reasoning. To the extent he means to challenge the existence of a "duty to disclose," however, his argument fails, since New York courts have consistently held that fraud can be committed through omission. *See, e.g., Gaidon v. Guardian Life Ins. Co.*, 94 N.Y.2d 330, 349 (1999).

Conclusion

For the foregoing reasons, the Bankruptcy Court Order is affirmed. The Clerk of Court shall close the case.

SO ORDERED:

Dated: New York, New York
July 20, 2006

s/ Denise Cote
DENISE COTE
United States District Judge

APPENDIX C — EXCERPTS FROM THE BANKRUPTCY COURT DECISION DATED JULY 7, 2005

[Commencing at page 9]

* * *

THE COURT: Okay. All right. I have in front of me a motion for summary judgment by the plaintiff, Mr. Mehrlich, in this adversary proceeding, under Bankruptcy Rule 7056, which incorporates Federal Rules of Civil Procedures 56 C, which provides that summary judgment shall be granted if the pleadings, depositions and answers to interrogatories and omissions on file, together with the affidavit, if any, show, that there's no genuine issue as to a material fact and that the moving party is entitled to judgment as a matter of law.

In deciding a motion for summary judgment, the court must determine if there are any material factual issues to be tried, while at the same time resolving ambiguities and drawing reasonable inferences against the moving party. See 90 versus US Fire Insurance 804 F2d 7911 Second Circuit 1986.

The underlying cause of action here is one under Section 523(a)(2)(a) of the Bankruptcy Code. To determine that Mr. Mehrlich's claim is [10] not dischargeable from Mr. Dobbs' bankruptcy case.

To prevail on such a claim, the plaintiff must show by a preponderance of the evidence the criteria set form in Section 523(a)(2)(a). It should be noted however, that

Appendix C

Section 523 should be strictly construed against the objecting creditor and liberally in favor of the debtor, consistent with the fresh start policy under the Bankruptcy Code. See generally 4 Collier On Bankruptcy paragraph 523.5. Here Mr. Mehrlich relies upon the doctrine of collateral estoppel, which may be invoked in non dischargeability actions on a motion for summary judgment. See Grogan versus Garner at 498 US 279 in 1991, as well as Zois Concrete at 269 BR 89 at 97 Bankruptcy Court Second Circuit Direct of New York 1999.

A party also may be collaterally estopped from relitigating issues that were decided in an arbitration proceeding, which is what Mr. Mehrlich relies on here. See Boguslabsky versus Kaplan 159 F.3d 715, 720 Second Circuit 1998. Collateral estoppel applies if, one, the identical issues was raised in a prior proceeding, the issue was actually litigated and decided in that [11] proceeding, the party had a full and fair opportunity to litigate the issue, and finally, resolution of the issue was necessary to support a valid and final judgment on the merits.

If collateral estoppel is applicable, then the court must also determine if the issue in the prior preceding was identical, if the elements under the particular bankruptcy statute were invoked, and the issues were necessarily decided. See Zois again at 269 B.R. 98. Of course, collateral estoppel applies even if the subject matter in the second proceeding, i.e. non dischargeability is not as the same in the first as long as the elements of collateral estoppel are met.

Appendix C

Here, it should be noted in particular that the arbitrator was fully aware that his decision might be used in a non dischargeability litigation. He makes that point on page two of his decision. I conclude therefore, although I need debt for collateral estoppel to apply, that the arbitrator was particularly careful as to his factual findings as to how they might pertain to a subsequent issue of dischargeability. [12] The statute, Section 523 (a) (2) (a) provides that a debt will be non dischargeable if it is for money, property services, or extension renewal or retention of credit to the extent obtained by false pretenses, a false representation, or actual fraud other than a statement respecting the debtors or insiders financial condition.

It's been noted that the statute's factors are set forth in the disjunctive, and that false pretenses and/or false representation are not necessarily the same as actual fraud. In this case the arbitrator specifically found that there was actual fraud under New York law in connection with Mr. Dobbs' communications with Mr. Mehrlich regarding the funds investment, the formula funds investment in the Americon stock and the value of that investment. He so found on page 19 as well as on page 20, in which he said, "Dobbs not only had a fiduciary duty to disclose by reason of his status as the person who controlled the funds manager, but once he voluntarily undertook to explain the 1998 year end results to Mehrlich, he assumed the duty to speak truthfully and completely. He did not do so. These omissions continued through the fund's [13] incomplete statements in its quarterly reports and in K-1s for 1998 and 1999." He later found on page 22, "if Dobbs had disclosed the Americon Holding and its valuation, Mehrlich

would have withdrawn from the fund at the end of 1998." And he found in his ruling that that fact lead to Mehrlich's damages.

I find that those findings by the arbitrator do serve as a basis for the collateral estoppel under Section 523 (a) (2) (a) in that they were findings on both actual fraud under New York law, as well as false pretenses. Under New York law, actual fraud may be predicated not only upon an actual misrepresentation, but also a material omission. Such conduct may support a fraud cause of action if the omission was known to the defendant, made with the purpose of inducing the other party to rely on it, and the plaintiff has justifiably relied upon the omission and it has caused injury. See Lama Holding Company versus Smith Barney 88 New York 2nd 413-421 1996. A debtor's silence or failure to disclose a material fact may constitute fraud so as to preclude the discharge of the debt in Section 523 (a) (2) (a). See [14] In re Ruppino 221 B.R. at 693 701-03 Bankruptcy Southern District of New York 1998, in re Docktoroff 123 F.3d 210 Third Circuit 1997. In re Eashi 87 F.3d 1002 at 1009, Ninth Circuit 1996, and In re Miller 311 B.R. 227 at 761 District Court of Maryland 2004.

Moreover, Section 523(a)(2)(a) does not require that a person's conduct include the actual false representations or actual fraud is normally required in a classic sense, but rather the disjunct of the statute false pretense makes it clear that that type of conduct fits within the provision as well. See In re Ruppino 221 B.R. at 701. Ordinarily a proof of fraud claim, one would show there was a false representation made that the plaintiff

reasonably or justifiably relied upon it and was injured. In order to show a false pretense, one need not prove the first two elements of a classic fraud, that is, a false representation. However, this does not eliminate the requirement the plaintiff must prove, one, the debtor engaged in conduct that wronged one of his property rights by dishonest methods or schemes such as deprivation of something of value by trick, [15] deceit, chicane or overreaching. In re Ruppino 221 B.R. at 701 quoting Carpenter versus United States 404 US 19-27 1987. The arbitrator's findings therefore also established that Mr. Mehrlich's claim derives from the debtor's false pretense with regard to the investment in the Americon and Americon's value which wrongfully deprived Mr. Mehrlich of his property rights by luring him into remaining in the fund as an investor.

Again, I note making a material omission constitutes fraud under New York law, and in that basis also is satisfied, i.e., believed that the arbitrator's reference to a fiduciary duty by Mr. Dobbs on page 20 as the arbitrator himself acknowledges is superfluous given the facts that he outlines. The real duty here was Mr. Dobbs' duty, having provided partial and incorrect information to give Mr. Mehrlich a full picture and not to omit material disclosure with regard to the funds investment in Americon and the valuation of Americon, either one of which the arbitrator found would have lead Mr. Mehrlich to terminate his investment in the fund.

So based on that, I conclude that [16] the summary judgment motion should be granted.

* * * *

APPENDIX D — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DENYING PETITION FOR REHEARING FILED SEPTEMBER 11, 2007

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT
THURGOOD MARSHALL U.S. COURT HOUSE
40 FOLEY SQUARE, NEW YORK, N.Y. 10007

Catherine O'Hagan Wolfe
CLERK OF COURT

Date:

Docket Number: 06-3885-bk

Short Title: In Re: Billy D. Dobbs, Jr. v.

DC Docket Number: 05-cv-____

DC: SDNY (NEW YORK CITY)

DC Judge: Honorable Denise Cote

At a stated term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the 11th day of September two thousand seven.

In re: Billy D. Dobbs, Jr.

Appendix D

A petition for panel rehearing and a petition for rehearing en banc having been filed herein by the appellant Billy D. Dobbs, Jr. Upon consideration by the panel that decided the appeal, it is Ordered that said petition for rehearing is **DENIED.**

It is further noted that the petition for rehearing en banc has been transmitted to the judges for the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

FOR THE COURT
CATHERINE O'HAGAN WOLFE, Clerk

by s/ Molly A. Guptill
Molly A. Guptill,
Acting Motions Staff Attorney

APPENDIX E — DECISION OF ARBITRATOR OF THE AMERICAN ARBITRATION ASSOCIATION, COMMERCIAL ARBITRATION TRIBUNAL DATED FEBRUARY 8, 2002

AMERICAN ARBITRATION ASSOCIATION
COMMERCIAL ARBITRATION TRIBUNAL

Case No. 13 168 004162

In the Matter of Arbitration Between

RICHARD W. MEHRLICH

Claimant,

-and-

BILLY D. DOBBS, JR. and FORMULA FUND MANAGEMENT, L.L.C.

Respondents.

DECISION OF ARBITRATOR

This arbitration was commenced on or about February 8, 2002 with the filing of a Demand for Arbitration by the Claimant, Richard W. Mehrlich ("Mehrlich"). The Demand seeks compensation for losses suffered in connection with Mehrlich's $2 million investment in Formula Fund, L.L.C. ("Formula Fund" or "the Fund"). Formula Fund is a hedge fund managed by Formula Fund Management, L.L.C. ("Formula-

Management" or "the Manager"). Formula-Management is controlled by the individual Respondent, Billy D. Dobbs Jr. ("Dobbs"). Dobbs made all investment decisions for the Fund. The Respondents, through counsel, filed a Response dated November 25, 2002 denying liability. On the eve of the scheduled hearings on the merits, Dobbs filed a personal bankruptcy petition in the United States Bankruptcy Court for the Southern District of New York, Case No. 03-17622. The filing of the bankruptcy petition triggered the automatic stay provisions of the Bankruptcy Code, and the hearings were adjourned *sine die.* By Order dated January 22, 2004, U.S. Bankruptcy Judge Robert D. Drain modified the automatic stay pursuant to 11 U.S.C. Sec. 362(d) to enable the arbitration to proceed to award. Mehrlich applied to lift the automatic stay in the hope of proving the elements of a non-dischargeable debt under 11 U.S.C. Sec. 523. A reasoned award is, therefore, appropriate.

By the time the stay was lifted, Dobbs was no longer represented by counsel, and he appeared *pro se* through the remainder of the proceedings. In that capacity, Dobbs testified on his own behalf, and examined and cross-examined witnesses. In all, eight witnesses presented testimony over five days of hearings. Hearings on the merits were conducted on April 21 and 22, May 19 and 20 and August 20, 2004. The last hearing was conducted to accommodate the Claimant who called two additional witnesses who did not initially testify in his case in chief. The witnesses who testified were: Kenneth B. Katzman, an expert called by the Claimant;

Beverly Mehrlich, the Claimant's spouse; Richard Mehrlich, the Claimant; Jennifer Wallace, Mr. Dobbs' spouse; Billy Dobbs; John Davenport, Mr. Mehrlich's broker; Joseph Aaron, a principal in the firm of May, Stone & Caddis; and John Reeder, a former friend of Mr. Dobbs and a former director of the offshore hedge fund managed by Mr. Dobbs called Formula Offshore Investment Fund ("Formula Offshore Fund"). Mehrlich also offered deposition transcripts of Dobbs and a Mr. William Schatten, taken in the context of a lawsuit entitled *Halifax Fund, LP v. Formula Offshore Investment Fund, et al.*, (Supreme Court of the State of New York, Index No. 602585/01).

Documents were exchanged by the parties prior to the hearings, and both sides offered documentary evidence in support of their positions.[1] Post-hearing briefs and reply briefs were also exchanged.

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1. In that regard, Mr. Dobbs stated that the Respondents' prior counsel had possession of additional documents perhaps helpful to Mr. Dobbs' case that he was unable to recover. According to Mr. Dobbs, his prior counsel had refused to redeliver the files to Mr. Dobbs, presumably in view of a fee dispute. The Arbitrator notes that, by the time the bankruptcy petition had been filed, both sides had been ordered, and presumably did, make document disclosure, one to the other. In addition, the Arbitrator issued two subpoenas, one directed to Dobbs and Formula Fund and the other to Dobbs' prior counsel for the production of at least some of the allegedly missing documents and for whatever reason, no additional documents were produced. The arbitrator further notes that in the course of the hearings Mr. Dobbs did produce documents from his prior counsel's law office, some of which he said he had obtained with the cooperation of his prior counsel's law partner.

Appendix E

The facts, as demonstrated by the evidence, are as follows:

Mehrlich's Initial Decision to Invest

Mehrlich is a businessman who, in 1980, started a company called Systems Plus, a software publisher, *i.e.* a company in the business of marketing software programs written by others. In or about the end of 1996, Systems Plus merged with a company called Medical Manager. Medical Manager had a software product of its own that it marketed to physicians. In February 1997 the merged company went public in a successful IPO. Mehrlich received cash and a considerable amount of restricted stock. He then decided to diversify by borrowing against the restricted stock that he received in the IPO and investing the proceeds. Mehrlich, an experienced investor, wished to explore hedge funds as possible investment vehicles. Towards that end, he sought recommendations from a trusted stockbroker, John Davenport. Davenport at the time worked in the San Francisco office of Donaldson, Lufkin & Jenrette.

Davenport admittedly knew little of hedge funds and, through a contact at his office, was introduced to one Joseph M. Aaron ("Aaron"). Aaron was the principal of a company named May, Stone & Caddis (MSC). MSC was in the business of introducing hedge fund managers seeking investment capital to potential investors. These introductions were made through seminars or symposia sponsored by MSC. MSC received compensation in the

form of a percentage of the investment funds that it succeeded in introducing to a fund manager.[2]

Aaron, who lived near Davenport, met with him sometime in the summer of 1997. At their meeting, Aaron discussed with Davenport various investment approaches used by hedge fund managers, including the so-called Jones model. That particular approach appealed to Davenport and, based on Davenport's preference, Aaron recommended about 20 fund managers. Dobbs was one of them. Aaron also gave Davenport a booklet that MSC had prepared for use in a July symposium that MSC was sponsoring in Chicago. The book contained a description of the hedge funds that intended to make presentations at the symposium together with a description of the investment managers

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2. While not directly relevant to the ultimate issues raised in this arbitration, Aaron, in January 1996—unbeknownst to Davenport and Mehrlich at the time—was charged in an SEC complaint with violations of Section 17(a) of the 1933 Act and Section 10(b) and Rule 10b-5 of the 1934 Act in connection with the activities of a company called Chartwell Financial. Without admitting or denying the allegations of the complaint, Aaron consented to the entry of an order enjoining him from future violations of Section 17(a) and Section 10(b) and Rule 10b-5. A civil penalty was also imposed. In his testimony, Aaron stated that the SEC consent order was based upon his failure to supervise others and was not the product of any fraudulent activity. Aaron further testified that he made all fund managers with whom he did business fully aware of the prior SEC proceeding. Dobbs observed at the hearings that the name of Aaron's business, "May, Stone & Caddis" was derived from the names of lures used as bait by fly fishermen.

for each fund.[3] Several pages of the booklet were devoted to Formula Fund and Dobbs. The booklet's description of Dobbs included the following: "He does not manage separate accounts nor does he own stocks outside the fund."

Davenport then met with Mehrlich and they reviewed the information and the materials that Davenport had received from Aaron. At their meeting, Davenport and Mehrlich pared the list of potential managers to about 10 or 12. Dobbs was one of the contenders. Both Mehrlich and Davenport testified that Mehrlich relied on, among other things, the representation that Dobbs would not own stocks outside of the fund. Mehrlich testified that this representation "was of great importance" to him because "there [would be] no separate accounts, no game playing ... on the side by managers of the fund by investing in stocks themselves or other activities." (Tr. 530).

After his meeting with Mehrlich, either Aaron or Dobbs arranged a personal meeting between Dobbs and Davenport, and the two met in Davenport's office sometime in the Fall of 1997.

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3. Variants of the booklet that Aaron handed to Davenport were used in three symposia sponsored by MSC. The first symposium was conducted on July 14, 1997 in Chicago, the second on February 17, 1998 in New York, and the third on September 8, 1998 also in New York. Dobbs presented in Chicago and at the second New York symposium.

Davenport was impressed by Dobbs and his stated investment approach. After Davenport did his further diligence on the fund managers, he presented his findings to Mehrlich who eventually decided to invest in six different hedge funds, including Formula Fund Mehrlich then wired $2 million to Formula Fund in December 1997.

In connection with his investment, Mehrlich executed several documents including a Formula Fund L.L.C. Offering Memorandum, Operating Agreement, Subscription Agreement and Investment Suitability Questionnaire.[4]

Formula Fund's Performance Through The Third Quarter of 1998 And Mehrlich's Decision To Redeem

In March 1998 Mehrlich received his K-1 form reflecting his share of the Fund's profit or loss for the month of December 1997, the period in which Mehrlich participated for that year. The K-1 showed a $79,000 loss. Although disappointed, Mehrlich viewed this as part of the risk of investing and took no action to withdraw from the Fund. Through 1998 Dobbs sent Mehrlich quarterly statements purporting to reflect the Fund's

4. Neither side produced executed copies of the investment documents and none were entered into evidence at the arbitration. By Decision dated May 28, 2004, however, the Arbitrator determined by a preponderance of the evidence that Mehrlich in fact executed the documents or was estopped from denying that he had done so.

investment performance. The statements reported that Formula Fund was, net of all fees, up 7.39% in the first quarter of 1998; up 2.54% in the second quarter; down 0.39% in the third quarter; and down 13.01% for the fourth quarter. For all of 1998, the quarterly report dated January 15, 1999 stated that the Fund's annual performance was down 0.96% versus a total return of 28.55% for the S&P 500.

Davenport and Mehrlich monitored the progress of Mehrlich's hedge fund investments, and based on their performance through the third quarter, Mehrlich decided to liquidate or to reduce his exposure in four of the six hedge funds in which he had originally invested. One of the funds he decided to redeem *in toto* was Formula Fund. Thus, on November 12, 1998, Mehrlich, through Davenport, sent a withdrawal notice to Dobbs requesting him to liquidate his limited partnership interest for cash delivery January 1, 1999. Davenport testified that he followed up Mehrlich's letter with a phone call on November 13th in which Dobbs acknowledged receipt of the redemption request and said "no problem" or words to that effect. Mehrlich, again through Davenport, then sent Dobbs a follow up letter on December 17, 1998 giving Dobbs wiring instructions for Mehrlich's account. Davenport also sent a fax to Mehrlich's bank on January 4th alerting the bank to expect wire transfers from the four funds, including Formula Fund, that were the subject of Mehrlich's redemption requests. Of these four funds, all but Formula Fund duly redeemed Mehrlich's investments.

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On January 19, 1999 Dobbs telephoned Mehrlich together with one John Reeder, who, according to the Fund's January 1999 quarterly report, had joined Formula Fund as an analyst earlier that month. In that call, Dobbs asked Mehrlich why he wanted to redeem. Also in that conversation, which was followed-up with a letter from Dobbs of the same date, Dobbs asked Mehrlich to postpone his redemption pending a meeting at which Dobbs could fly out to speak to him to present reasons why Mehrlich ought to remain invested in the Fund. In his follow-up letter Dobbs confirmed that Mehrlich, in their conversation, agreed to "table your decision to redeem your investment in Formula Fund LLC pending an in-person visit by us . . ." (Claimant's exhibit 31). If Mehrlich continued with the Fund, the letter also offered an "8% hurdle-rate" as a condition to Dobbs' earning any performance fees. The letter went on to express optimism in the future and stated, "With the exception of a tricky October [1998], we are encouraged by our twenty-two month historical performance." *Id.* The Formula Fund quarterly report dated January 15, 1999 was attached to the letter of January 19th. It reflected a negative 21.33% performance for October 1998.

Formula Fund's Investment in Amercon

Meanwhile, early in 1998 events began to unfold that had a significant bearing on the direction and future of Formula Fund. In February 1998 Dobbs invested both his own personal funds and those of Formula Fund in a start-up company that manufactured aircraft parts

named Amercon International Incorporated ("Amercon"). Originally, Dobbs, for his own account, purchased 189 shares of Amercon in its initial offering at $450.00 per share, and caused Formula Fund to purchase 1,464 shares of Amercon, also at $450.00 per share. Either at that time, or shortly thereafter, Dobbs also became Chairman of Amercon's Board of Directors.

Amercon sold a small number of additional shares (549 shares in total) in or about October of 1998 at a price of $1,825.00 per share. Dobbs purchased additional shares at that time for his own account and caused Formula Fund to buy additional shares as well. The 1998 year-end brokerage statement for Formula Fund (Claimant's exhibit 12) reflects that Formula Fund held, at the end of 1998, 1,611.22 shares of Amercon carried at a cost of $450.00 per share. This totaled $725,050.00, a sum that represented about 18% of Formula Fund's total portfolio at cost (and about 12% of its total long positions at cost) at year end 1998.[5]

Mehrlich testified that, at the time he decided to invest in Formula Fund, he had assumed that the vast percentage of the Fund's trading was done in publicly traded securities. He testified that he had little interest in investing in a hedge fund that would purchase privately held, illiquid securities. After all, Mehrlich was

5. According to the brokerage statement, Formula Fund's portfolio value at cost on 12/31/98 was $4,044,899.59 calculated by taking Formula Fund's long positions, at cost, totaling $6,196,639.32 and subtracting the Fund's short positions of $552,866.17 and subtracting its cash of $1,598,873.56.

motivated to diversify because of the concentration of his wealth in a block of restricted stock that he obtained in the Medical Manager IPO in early 1997. Both Mehrlich and Davenport also testified that the statement attributed to Dobbs in the MSC booklet that Dobbs would not own stock outside of the Fund was a *sine qua non* of Mehrlich's decision to invest.

Dobbs on the other hand, denied that he authored the statements in the MSC booklet or authorized Aaron to make them on his behalf (something Aaron strongly contested in his testimony), Dobbs also pointed to Article 6.1(c) of the standard Formula Fund L.L.C. Operating Agreement, a document presumably executed by Mehrlich.[6] That Section states that "The Manager [Formula-Management] shall use its best efforts to carry out the objectives and purposes of the [Fund] ... provided, however, that nothing contained in this Section 6.1 shall preclude the Manager or any affiliate of the Manager ... from trading in securities for his own account."[7] Further, while the "Summary of Offering" set forth in the Fund's Offering Memorandum, entered into evidence as Respondent's exhibit 3, states under the

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6. The exhibit entered into evidence, Respondent's exhibit R-1, is a copy of the Operating Agreement between Dobbs and Formula Fund L.L.C. As set forth above, Mehrlich presumably executed this standard form as well, even though investment documents signed by Mehrlich were never offered into evidence.

7. A similar statement appears on page 23 of the Offering Memorandum under the heading "Potential Conflicts of Interest."

heading "Investment Policies" that the fund will invest "principally in the stock of U.S. public companies", the paragraph continues as follows: "The [Fund] may also invest to a lesser extent in private investment companies . . ." Mehrlich acknowledged in his testimony that he would not have felt aggrieved if the Fund had invested some of its assets in a private placement (and, indeed, later in 2000 did not express surprise by the fact that the redemption of his interest might involve the transfer to him of restricted securities, *see* Claimant's exhibit 37). However, his consistent expectation was that the Fund would dominantly trade publicly listed securities.

It is undisputed, however, that Formula Fund—by the end of 1998—owned a substantial stake in Amercon. It is also undisputed that these securities were carried at a price of $450.00 per share until Dobbs, sometime towards the end of 1998 or the beginning of 1999 decided to revalue them.

The Revaluation of Amercon

It appears from the quarterly statements sent by Dobbs that 1998 was a difficult year for the Fund. According to the January 1999 statement that valued the Fund's full year 1998 performance, Formula Fund lost 0.96% for the year versus a positive return of 28.55% for the S&P 500. Indeed, the Fund reportedly suffered a negative 21.33% performance in the month of October 1998 alone.

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John Reeder testified, however, that the Fund's performance in 1998 was far worse than that communicated to its investors. Reeder was a personal friend and classmate of Dobbs who Dobbs employed for a short while beginning in early 1999. Reeder was ostensibly hired as an analyst, but essentially worked editing a Fund newsletter and assisted in Dobbs' attempts to raise additional capital. Reeder and Dobbs were part of a network of Columbia Business School classmates who remained friends and who continued to network after their graduation. Reeder's brother was an investor in Amercon and Dobbs recruited Reeder as a Director of the Formula Offshore Fund, where Reeder served until his resignation in September of 1999.

According to Reeder's testimony, Dobbs suffered a 55% trading loss in October of 1998 and not the lesser 21.33% loss reported on the Fund's quarterly report. Reeder further testified that Dobbs, knowing that the reporting of that loss would spell doom for the Fund, concealed the October loss by revaluing upwards the Amercon stock held by the Fund. The 1998 year end brokerage statement for the Fund (Claimant's exhibit 12) recites the "Market Value" of the Fund's 1,611.22 Amercon shares as $4,753,105.49 or $2,950.00 per share. A valuation of $2,950.00 per share enabled the Fund to report a 21.33% loss in October and a near break-even performance for the year.

Dobbs acknowledged that he placed the $2,950.00 valuation on the Amercon stock in a letter dated April 2, 1999 to BDO Seidman, the Fund's accountants.

In that letter, he sought to explain his valuation as follows: "The $2,950 per share valuation of Amercon International reflects an approximately 16% discount to the equity offering in February 1999 of $3,500 per share. . . . The $3,500 price per share was determined by using a multiple of 3.5x Q4 run rate EBITDA . . ." (Claimant's exhibit 13). Dobbs defined the phrase "Q4 run rate EBITDA" as the prediction for Amercon's fourth quarter 1999 cash flow.

At the hearings Dobbs sought further to justify his upward valuation of Amercon in a number of ways. He pointed out that the valuation of a privately held security is not an exact science and that using a multiple of assumed future cash flow was one way to arrive at a fair value. He also stated that, in early 1999, Amercon conducted an offering at $3,500.00 per share. An exhibit proffered by Dobbs (Respondent's exhibit 11A) consists of a form letter addressed to "Dear _____" and dated "____ date ____, 1999". It purports to offer 286 shares of Amercon stock at $3,500.00 per share. Additional exhibits are consistent with a 1999 offering at $3,500.00 per share. *See, e.g.*, Claimant's exhibit 17 at page 11. The record, however, is unclear as to whether any Amercon shares were actually sold to investors at that price, and, if so, how many. Further, the total number of shares offered was quite small, A letter to Amercon shareholders dated November 4, 1999 offering 22,604 shares of Amercon at $35.40 per share (exhibit 7 to the deposition of Mr. Dobbs taken in the *Halifax* litigation, part of Claimant's exhibit 10) contains a section entitled "PRIOR OFFERINGS". No prior offering at $3,500.00 per share is listed.

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Dobbs, in order to justify the valuation that he had placed on the Fund's Amercon shares, also referred to Section 3.7 of the Operating Agreement which provides: "[S]ecurities for which market prices are not readily available . . . are valued at fair market values determined in good faith by the Manager. Notwithstanding the foregoing, the Manager reserves the right to determine the fair market values of all assets held by the [Fund] using reasonable valuation techniques other than as stated above, provided that any such determination shall be based on the Manager's good faith determination regarding the reasonableness of such values. The values . . . determined by the Manager shall be final and conclusive."

Mehrlich claimed that Dobbs made the upward valuation in bad faith in order to conceal the Fund's poor performance and in order to generate management fees. Dobbs, as explained above, argued that the valuation was justifiable at the time especially with reference to a privately held, illiquid security. Whatever the motivation, the upward valuation of Amercon increased the value of the Amercon holdings on the books of Formula Fund from $725,050.00 (at $450.00 per share) to $4,753,105.49 (at $2,950.00 per share). It also made the Fund's Amercon stock holding equal to over 50% of the Fund's assets as of the end of 1998.

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Dobbs' Meeting With Mehrlich

It was against this background that Dobbs and Reeder met with Mehrlich in California in early February 1999 in an attempt to dissuade Mehrlich from redeeming his investment in the Fund. The meeting was attended by Mr. and Mrs. Mehrlich, Dobbs, Reeder and Davenport. It lasted about two hours. Mehrlich reiterated his disappointment with the Fund's lackluster performance. Dobbs sought to reassure him. Dobbs and Mehrlich discussed the Funds' investment in a small golf equipment company named Coastcast and its potential for substantial gain. Dobbs reiterated his offer of an 8% hurdle rate that the Fund would have to achieve before Dobbs could earn a management fee. Dobbs also explained reasons for the trading errors that resulted in the Fund's poor October performance and talked about instituting a new matrix trading system that the Fund would use to avoid the undue concentrations in particular market sectors that had led to the October trading losses. Dobbs also promised to participate in monthly telephone calls with Mehrlich to keep him apprised of the Fund's performance and any new developments.

According to the Mehrlichs, Davenport and Reeder, Dobbs never once mentioned Amercon at the meeting, nor the fact that, at the year-end value he had ascribed to the stock, Amercon represented well over half of Formula Fund's stated value. The Mehrlichs and Davenport testified that at no time did they know or suspect that Formula Fund held a substantial position in a non-public illiquid security, nor, of course, were they

aware of the percentage value of the Fund represented by the Amercon stock. Reeder testified that he himself was unaware of the extent of the Fund's investment in Amercon—or the percentage of the Fund represented by Amercon— until some weeks after the meeting with the Mehrlichs and Davenport.

Relying on what he had heard from Dobbs at the meeting, Mehrlich withdrew his total redemption request and decided instead to withdraw only $500,000. By letter dated February 8, 1999 (Claimant's exhibit 32) Dobbs agreed to send Mehrlich a check for $500,000 in the first week of March. Mehrlich subsequently received his K-1 for 1998 (Claimant's exhibit 21). Because of the upward valuation of Formula Fund's Amercon stock, the K-1 showed a reduction of only $29,063 in Mehrlich's capital account for 1998 leaving a year-end balance of $1,891,559. In addition, Mehrlich continued to receive quarterly reports. Two of them, one dated July 15, 1999 and the other dated October 15, 1999 were entered into evidence (part of Claimant's exhibit 33).[8] Neither of the quarterly reports disclosed the Amercon investment although each of them contained detailed descriptions of "Some Current Long Positions." In view of the small loss reported in the K-1 for 1998 and the optimistic quarterly reports received in 1999, Mehrlich did not press his request for a $500,000 withdrawal and Dobbs never sent it.

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8. No first quarter 1999 quarterly report was entered into evidence, but this may have been simply due to the fact that none surfaced in the course of document production. Presumably, a first quarter 1999 report was issued.

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Dobbs' Continuing Valuation of Amercon Through 1999 and 2000

The $2,950.00 per share valuation that Dobbs originally made in late 1998 or early 1999 was maintained throughout 1999 and 2000. One exhibit, Claimant's exhibit 39A, reflects a valuation of $2,950.00 per share, or higher, for the Formula Offshore Fund in the latter months of 2000, and the clear inference is that the domestic fund, *i.e.* Formula Fund, was valued using the same numbers. The continued use of the $2,950,00 (or higher) figure is also confirmed by another Claimant's exhibit. According to Claimant's exhibit 24, which is Formula Fund's capital account summary for the year ended December 31, 1999, at least six investors redeemed their capital in 1999. The names of these investors were redacted in the exhibit when it was produced and during his testimony Dobbs was asked whether he could identify the investors who redeemed. He said that he could not recall and that the accountants had prepared the original exhibit.[9] Three of the six Formula Fund investors who redeemed in course of 1999 received amounts greater than their opening capital. The other three were able to redeem at least 90% of their

9. The Claimant had speculated that Dobbs cashed out his friends while leaving Mehrlich and other less favored investors to suffer the ultimate loss. Dobbs denied that this occurred. Further, Jennifer Wallace, Dobbs' spouse, testified that she remained in the Fund during that period as did other family members. The arbitrator issued two subpoenas which were sent to the parties calling for Dobbs, Formula Fund and Dobbs' prior counsel to disclose the unredacted exhibit. The unredacted exhibit never appeared at the hearing.

opening 1999 capital as reflected on exhibit 24, thus indicating that Amercon was carried at the same or substantially the same share value through at least the end of 1999.

This $2,950.00 per share (or higher) valuation persisted despite additional Amercon stock offerings in 1999 and 2000 at share prices substantially below $2,950.00 per share, coupled with a poor financial performance by the company that would appear to have destroyed any justification for the $3,500.00 per share figure on which the $2,950.00 valuation had been based. In late October 1999 the Amercon shareholders conducted an offering to sell up to 22,604 shares at only $35.40 per share. The shareholders made that determination in a document entitled "AMERCON ... STOCKHOLDER ACTION BY WRITTEN CONSENT IN LIEU OF A MEETING" ("the Written Consent") (Exhibit 11 to the deposition of Mr. Dobbs conducted in the *Halifax* litigation, part of Claimant's exhibit 10). The Written Consent contains the following paragraph:

> WHEREAS, the Stockholders estimate that the fair market value of the Corporation's outstanding common stock is $200,000, or $35.40 per share, and wish to price the private placement on that basis;

There is a signature line for Dobbs' signature on the Written Consent. Dobbs' signature, however, does not appear. In his deposition testimony in the *Halifax* litigation, Dobbs testified that he did not recall signing

the document but that he had no reason to believe he did not sign it (*Halifax* dep. tr. 146). A letter subsequently sent on Amercon letterhead addressed "Dear Bill" reiterates the $35.40 per share offer and includes the following statement: "As you know, over the last several months, Amercon has suffered from and continues to suffer from severe financial difficulties. These difficulties have put Amercon's viability as a going concern into real doubt." (Claimant's exhibit 16). Another offering dated February 18, 2000 sought to sell up to 6,250 Amercon shares at $80.00 per share. Both of those offering prices were a far cry from $3,500.00 per share and, of course, Amercon never achieved a fourth quarter 1999 EBITDA that would have justified the $3,500.00 offering price that Dobbs had initially used to arrive at his $2,950.00 per share valuation.

Mehrlich's Renewed Decision To Redeem

Still unaware of the very existence of an investment called Amercon, but disappointed that Formula Fund had not realized his expectations, Mehrlich decided to redeem $1,000.000.00 of his investment at the end of 1999. On December 6, 1999 Mehrlich sent a letter to Dobbs requesting his funds (Claimant's exhibit 19). Davenport testified that he pressed Dobbs for the funds in early 2000 but that Dobbs either put him off or was unavailable to take his calls. In or about March of 2000 Mehrlich then received his K-1 for 1999 (Claimant's exhibit 22). It showed an increase of $436,791 in his capital account. Pleased with the Fund's 1999 performance as reflected on the K-1, Mehrlich did not insist on the return of the $1,000,000 that he had previously requested.

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As 2000 progressed, Mehrlich, thinking that was receiving a "decent return" (Tr. 605) continued with Formula Fund. After April 2000, however, he no longer received any quarterly reports, and his phone contacts with Dobbs became infrequent. Towards the end of 2000 he decided finally to redeem his investment. On October 26, 2000 Mehrlich, again through Davenport, sent a letter to Dobbs requesting a full redemption. A follow-up request was subsequently sent. (Claimant's exhibit 37). Mehrlich states in his letter of October 26th that be understands "that a certain portion of the funds may he in restricted securities". *Id.* Mehrlich testified (Tr. 614-615) that, as far as he was aware, the "restricted securities" to which he referred related to a possible position in Coastcast. At that point Mehrlich had still never heard of Amercon.

Finally, in February 2001 Mehrlich received $260,631 in full redemption of his $2,000,000 investment. A letter from Dobbs to Mehrlich dated February 12, 2001 (Claimant's exhibit 26) informing Mehrlich that his capital had been wired to him pursuant to his instructions expressed regret at the Fund's weak performance. The chart in the letter reflected a total loss in 2000 of over 88% and a loss in November alone of 71.37%.

Mehrlich testified that the first time he became aware of significant losses in the Fund was when he received his $260,631 and the accompanying letter that announced the losses. According to the testimony at the hearing, the downward valuation of Amercon and the revelation of the loss was triggered by a demand from

BDO Seidman, the Fund's accountants, that the Amercon investment be revalued to reflect its fair value.

This arbitration followed.

Legal Analysis

Mehrlich claims that the events described above constitute a fraud. "The elements constituting a cause of action for fraud are 'representation of a material existing fact, falsity, scienter, deception and injury.'" *New York University v. Continental Insurance Co.*, 87 N.Y.2d 308, 318, 639 N.Y.S.2d 283, 289 (Ct. App. 1995) *citing, Channel Master Corp. v. Aluminum Ltd. Sales, Inc.*, 4 N.Y.2d 403, 407, 176 N.Y.S.2d 259 (Ct. App. 1958). When the cause of action is based upon a material omission, the plaintiff must prove "a material omission of fact which was false and known to be false by defendant, made for the purpose of inducing the other party to rely upon it, justifiable reliance of the other party on the . . . material omission, and injury." *Lama Holding Co. v. Smith Barney Inc.*, 88 N.Y.2d 413, 421, 646 N.Y.S.2d 76, 80 (Ct. App. 1996). In New York, a civil fraud must be proven by clear and convincing evidence.[10]

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10. The Fund is a Delaware company, Mehrlich is a California resident, and Dobbs operated the Fund out of New York. New York was also the place of arbitration. This award analyzes the facts with reference to New York substantive law. California and Delaware have the same elements of a fraud, however, and the analysis would be the same. Further, to the extent that Dobbs' actions can he characterized as securities fraud, the essential elements would also be the same, albeit with certain added requirements, *e.g.* that the fraud be committed "in connection with" the purchase or sale of a security, etc.

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I find that the Claimant has proven the elements of a fraud as follows:

1. Dobbs' initial purchase of Amercon for the Fund and for his own account did not constitute a fraud *per se*. Mehrlich was aware or should have been aware that Formula Fund might trade in such securities, and no evidence was offered that Dobbs' personal interest in Amercon, or any trading of that personal interest, constituted self-dealing to the detriment of either Mehrlich or the Fund. As for the purchase of a privately held security, Mehrlich testified that he would not have felt aggrieved had he known that the Fund had taken a position in restricted stock and in his letter of October 2000 (exhibit 37) he states that he understood that part of his redemption might consist of restricted securities. While the statement attributed to Dobbs in the MSC brochure was untrue, Mehrlich did not rely upon it, at least to the extent that it promised that Formula Fund would never hold an illiquid security.

2. However, at the meeting in early February 1999, Dobbs had a duty to disclose truthfully the extent of the Fund's exposure in Amercon and the fact of the revaluation. At the value that Dobbs had ascribed to it, Amercon, an illiquid privately held security, represented well over half of the Fund's

stated value. Mehrlich had a right to know that fact before he decided to withdraw his redemption request and retain his investment. Dobbs not only had a fiduciary duty to disclose by reason of his status as the person who controlled the Funds' Manager, but once he voluntarily undertook to explain the 1998 year-end results to Mehrlich, he assumed a duty to speak truthfully and completely. He did not do so. These omissions continued through the Fund's incomplete statements in its quarterly reports and in the K-1s for 1998 and 1999.

3. I find that Dobbs' upward valuation of Amercon to $2,950.00 per share was done in bad faith to conceal the losses that would have otherwise come to light in 1998. Perhaps not coincidentally, Dobbs also earned substantial fees by reason of the upward valuation. A value of $2,950.00 per share was unjustified by any reasonable view of the state of Amercon or its future prospects. Indeed, the letter of November 4, 1999, discussed above, in a section entitled "PRIOR OFFERINGS" never even mentions a $3,500.00 per share offering. Even assuming, *arguendo*, that that valuation could have been justified at the time it was initially made, it would have been apparent at least by mid-1999 that the valuation was wildly inflated. Dobbs' failure

to revalue downward the Fund's Amercon holdings through all of 1999 and 2000 and his dissemination of incomplete quarterly reports supposedly reflecting the Fund's actual performance through 1999 and 2000 constituted a continuing deception.

4. Dobbs' wrongful upward revaluation of Amercon caused Mehrlich to believe that the Fund's 1998 losses were modest when in fact they were not. Mehrlich was deceived, and he reasonably relied upon Dobbs' failure to disclose by withdrawing his 1998 redemption notice and remaining in the Fund.

5. Mehrlich was damaged as calculated below.

The Damages

The Claimant is not entitled simply to the return of his initial investment of $2,000,000. The evidence is insufficient to demonstrate that Dobbs solicited the funds by fraudulent means. Some of the statements in the MSC materials proved to be untrue, but there is no clear and convincing evidence that they were made with the intent to deceive especially in view of the reservations set forth in the investment documents.

In addition, the Fund's mere purchase of Amercon, a privately held security, did not damage Mehrlich. There was no evidence that Dobbs personally profited from purchases or sales of Amercon stock (although the upward

valuation of the stock generated management fees). Further, I credit the testimony of Jennifer Wallace, Dobbs' spouse, to the effect that she herself lost money in the Fund as did several of Dobbs' own relatives. Dobbs clearly wanted the Fund to succeed. His error was in the investment decisions that he made and the ill-conceived efforts to buy time by over-valuing Amercon and then failing to disclose that investment and that valuation to his investors.

The measure of damages for fraud is "indemnity for the actual pecuniary loss sustained as the direct result of the wrong." *Lama Holding Co.*, *supra.*, 646 N.Y.S.2d at 80. If Dobbs had disclosed the Amercon holding and its valuation, Mehrlich would have withdrawn from the Fund at the end of 1998. His damages, therefore, are measured by the amount that he would have properly received had he withdrawn at the end of 1998 less what he ultimately did receive in 2001.

Mehrlich's K-1 for 1998 showed an ending capital account of $1,891,559. On exhibit 24, one investor—obviously Mehrlich—shows an opening capital account of $1,891,360.[11] Exhibit 24 shows total capital for Formula Fund as of the end of 1998 of $7,217,355. Thus, as of the end of 1998 Mehrlich had a 26.21% interest in the Fund ($1,891,360/$7,217,355).

Claimant's exhibit 12, the brokerage account summary for the year end 1998 values the total portfolio at cost at $4,044,900. The Fund, valued at market, but including Amercon valued at $450 per share, which I find to be fair

11. The exhibit is only partially legible and the digits are not completely clear.

value, is equal to $3,619,826, *i.e.* $7,647,881 (the total market value reflected on exhibit 12) less $4,028,055 (the excess of Amercon's value as valued by Dobbs over cost).

Thus, if Mehrlich had redeemed his interest in Formula Fund for value as at December 31, 1998, he would have received $948,756, or 26.21% of $3,619,826. Instead, Mehrlich received only $260,631.

I therefore find that Mehrlich sustained damages of $688,125 ($948,756 less $260,631).

Mehrlich would receive less if his damages were measured as of the end of 1999 or 2000. As explained at the text accompanying footnote 9 above, six investors withdrew or redeemed about $1,000,000 in 1999 (Claimant's exhibit 17, at page 8, reflects that $982,556 in Capital withdrawals occurred in 1999). The funds that Formula Fund utilized to pay for these six redemptions had to come from the liquidation of publicly traded securities in the Fund's portfolio. This would have had the effect of aggravating an already untenable situation by arithmetically increasing the percentage of the total portfolio value represented by Amercon and depleting the Fund's inventory of liquid securities available to pay redeeming investors.

It is therefore appropriate to assess damages as of the end of 1998.